RICHARD RUSSELL'S **DOW THEORY LETTERS, INC.**

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Nov. 21, DJIA 989.39; PTI 1371; A-D ratio –16.21
Nov. 28, DJIA 993.34; PTI 1381; A-D ratio –16.48

THE PICTURE: People are sick of the Mideast War and they are sick of Iran and its lies and its manipulations and they're so exasperated about the hostage situation that the whole thing has sort of fallen off the front pages as a news event. The one subject which has not faded away (my how the politicians wish it would) is inflation. Inflation is constant front-line news because it affects everyone every day of the year.

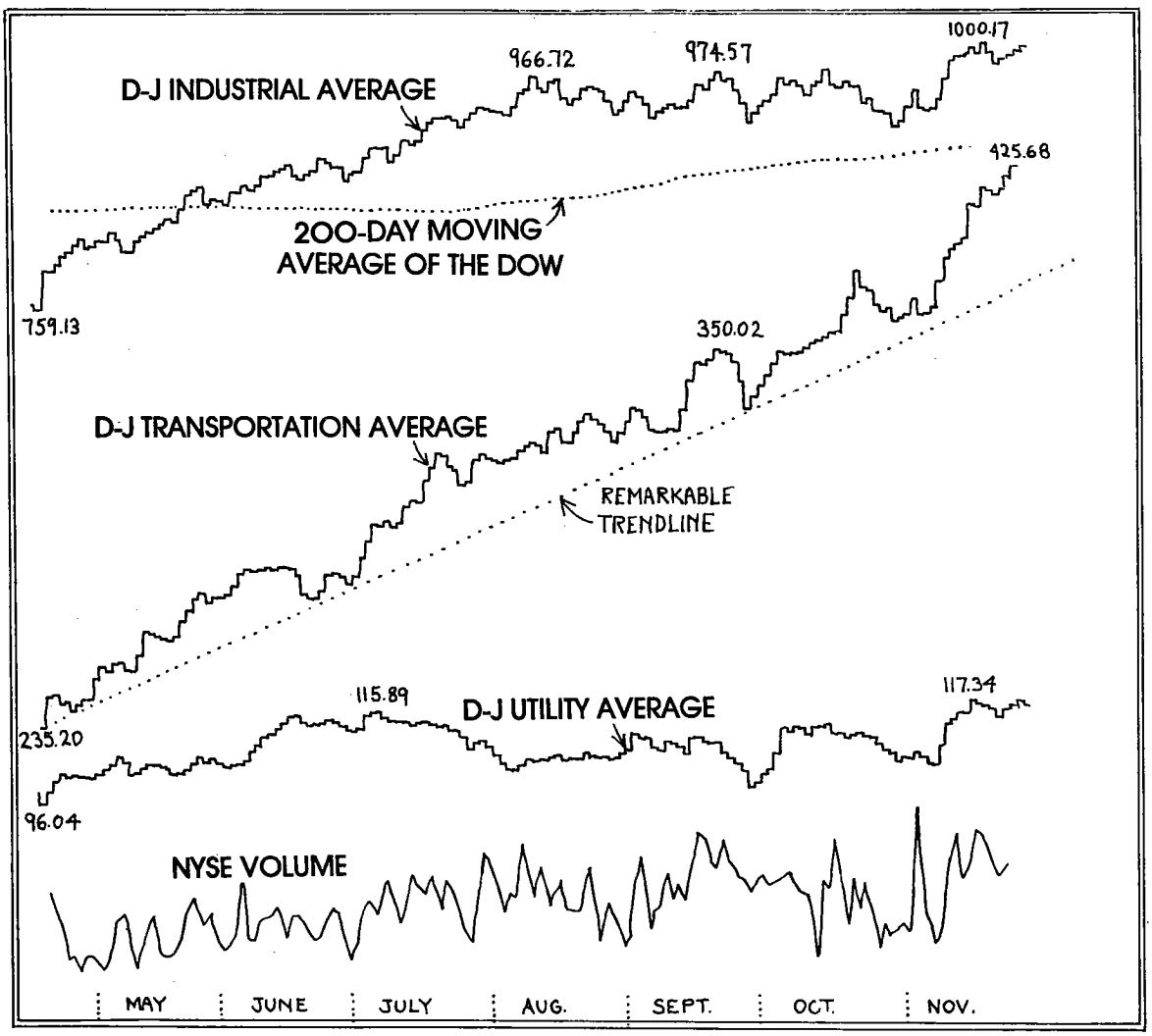
There's a lot of damn foolishness being bantered about today about inflation and how nobody and nothing can stop it. Suddenly, everyone is pointing to brave Maggie Thatcher's England and the great experiment. Sadly, we can see that the noble experiment is failing. "You can't knock inflation down," I'm told, "because look, England has the worst unemployment since World War II, England has high interest rates, England has a sagging economic mess on its hands, and it still has 22% inflation."

So I guess I should tell my subscribers the truth. There's only one thing that will knock inflation down—and that's a downturn in the primary trend of business and the markets. In the market that's known as a primary bear market. In business it is known as a depression. Presidential scoldings aren't going to end infla-

FRONT PAGE COMMENT: President Reagan will probably have the usual 6-month "honeymoon" once he takes office. Many liberals are now saying that "Maybe Ronnie won't be as bad as I thought he'd be," and "We'll give him some rope and see what he does." My own feeling is that the greatest danger will be a move by Reagan to "moderation." There's always the temptation on the part of a President to be a "good guy," to please (they call it "represent") the greatest number of people.

My own belief is that Reagan will not be a success unless the liberals start screaming. If you don't hear anguish from the liberals, if you don't hear Keynesians talk about "the end of the US as we know it," then Reagan will be another in a long list of failed US Presidents.

My number one criterion for a Reagan success will be the **amount that he cuts from the US budget.** This is the action which every US President talks about; it is the action that none carry through. Cutting the US budget to the bone will be Reagan's number one priority. If he fails to do that, everything else will wither away.
(Continued on page 2)



tion. Rising productivity isn't going to end inflation. Higher interest rates aren't going to end inflation. So far, all rising costs are passed on to the consumer in the form of higher prices, and that means more inflation, it's as simple and basic as that.

When the primary trend turns down it's a different story. Then we have true deflation. Deflation comes when merchandise is moved for whatever it will bring. Deflation arrives when people are looking for jobs, not wage boosts. Deflation comes when banks are afraid of losing money rather than customers. Deflation comes when inefficient businesses go "to the wall" rather than to the nearest government agency.

I know those things sound harsh, but inflation is even harsher because inflation not only wipes out everyone's earning power and savings, it ultimately will wipe out liberty and the free enterprise system.

Unfortunately, at this late stage of the game there's no leveling off, no painless period of dis-inflation. There's inflation and more inflation–or there's deflation. We've eliminated the possibility of the painless middle ground–as each new Administration finds out to its sorrow.

I've said this before, but I'll repeat it. With 5 trillion dollars of debt, the American system has *spent* its options. The sytem is now about as flexible as a 5000 year-old Egyptian mummy. We've had 40 years of inflationary fun, and now the pain is approaching. It's a case of inflationary pain or deflationary pain, and my guess is that the 1980's are going to see both. But enough of this, let's turn to the markets and see what they have to tell us.

Aside from watching the stock averages and individual stocks and the bonds and the PTI and dozens of other technical measurements, I do watch certain critical fundamental measurements. These measurements do not set the trend of the market, but they do tell me something about PRESSURE on the market.

For instance, right now the differential between the yield on the S&P 500 Stock Average and the yield on S&P's Aaa rated bonds is 7.87% in favor of the bonds. That's a near-record spread, and it implies pressure on equities. Another interesting spread is the differential between the yield on the Dow (5.5%) and the yield on 91-day T-bills (14.5). The differential is an incredible 9.0% in favor of super-safe T-bills, and this again puts pressure on equities.

A third ratio that I watch is the yield spread between very short-term money (I use 91-day T-bills) and the yield on one-year money (I use one-year t-bills). That yield spread is now 1.15% in favor of the 91-day bills, and this gives us what is terms a "negative" (or abnormal) yield spread. Normally, yields increase as maturities lengthen, but with short yields 1.15% above one-year yields it is clear that there is big PRESSURE on short-term money. The money markets are under pressure and that pressure is beginning to affect everything in all markets from commodities to bonds, from stocks to housing and cars.

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As readers know, the bearish segment of the last 233-day cycle (see chart in the last Letter) ran from August 15 to November 10. During that whole bear segment the Dow gave up a mere 30 points, and this in the face of a shocking amount of rotten news. By my calculations, a new 233-day cycle began on November 10, and the bullish segment of this new cycle is due to remain in force until early March. So I'm interested to see how much upside progress the market can muster during the bull segment of the new cycle. The bear segment of the last cycle couldn't force the market down very much. Let's see if the bull segment of the new cycle can drive the market up.

Two weeks ago Congress gave its approval to the new US budget which calls for $632.4 billion in spending and a planned deficit of $27.4 billion (not counting "off budget" expenses). This is a disgrace on the face of it. One Reagan confidant calls the 1981 budget "a lost cause" already.

The Reagan forces are currently talking about reducing expenses to the tune of 2%. To which I say, "Forget it, that doesn't begin to be enough." The Reagan administration has to go on a rampage of expense cutting, an absolute orgy. If they don't, the machine is going to break down.

In a book entitled, "Fat City," David Lambro documents more than $100 billion in government waste, fraud, nonsense, inefficiency. We will have to cut out that much and more (plus whole government departments) if this system and its currency is to be saved. For if we continue to run up deficits as we have over the last 10 years, the US will be heading for disaster–absolute disaster. I will stake whatever reputation I have on that statement.

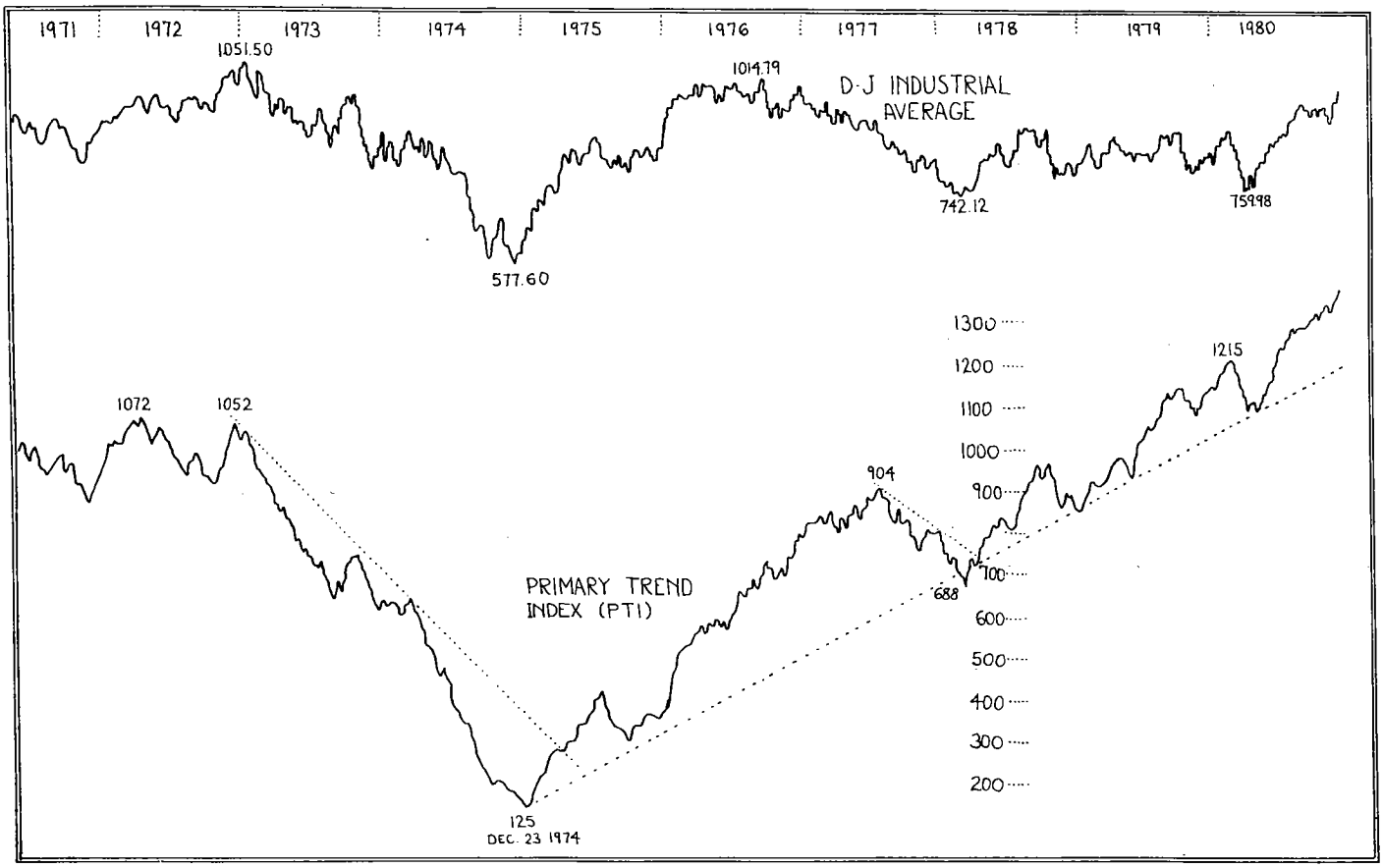
It is important to remember that the cycles represent a directional *tendency*, not an absolute. In other words, if the bull cycle is in force then positive news and positive fundamentals will tend to work very positively on the market while negative news and fundamentals will tend to exert a minimum downside pressure on the market.

From a Dow Theory standpoint the market's price structure (see page 1) remains bullishly intact. On November 20 the Industrial Average recorded a new high of 1000.17, and this was confirmed on the same day by a record Transport high of 414.43. Even the lagging Utilities got into the act by hitting a two-year high of 117.34 on November 18. A minor dip ensued, whereupon Transports lept to a new record high of above 420 while Industrials lagged.

This "cat-and-mouse" game has been played by the Averages ever since August, with Transports leading the way and Industrials finally following. Dow Theory now requires an Industrials bettering the November 20 peak of 1000.17. Failing that could be a first hint of trouble.

PRIMARY TREND INDEX: I've been an "exchange pal" of Joe Granville's for about 20 years (we've exchanged reports since 1961), and one of Joe's favorite admonitions is that stock market technicians should "never swing on a single branch." By that Joe means that you cannot draw valid conclusions from the action of a single indicator. In fact, Joe invariably looks for what he calls "the hook." The hook is that supposedly "infallible" indicator that everyone is watching this season. One year the hook may be the specialists' short sales, the next year it may be the "General Motors indicator," and a third year the hook may be the advance-decline line. The hook is the indicator that everyone follows (at which time it doesn't work).

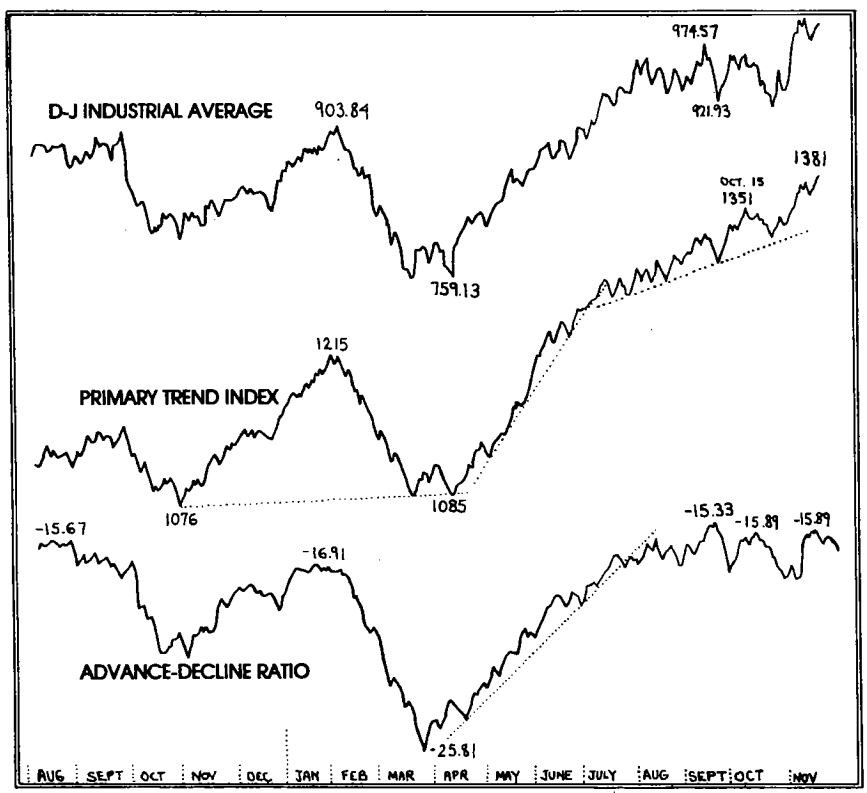
I thoroughly agree with Joe on the danger of following a single indicator. In Letters over the years, I have explained the hook principle in a slightly different way. I have said that the art of technical analysis is in knowing what indicator to throw out at any given time. What guides me, you or anyone else in knowing



when to jettison our favorite indicator? My only answer is–intuition and experience.

About 15 years ago I realized that it bothered me more and more to be so dependent on all the popular indicators, the indicators that everyone else watched and followed. I never had any doubt about the great value of technical analysis, and I never had any doubt about technical analysis as the road to consistent stock market profits. But I noticed that each technical indicator seemed to enter a period in which it became very popular. As soon as that particular indicator gathered a large following, it seemed to malfunction and lose its usefulness. So I began looking around for a way out of the technical predicament.

I had spent many years working with the Averages and volume on a pure Dow Theory basis. And I had learned to trust market action above all–rather than say market sentiment indicators or character of the market indicators. I had learned that the hardest things to fool or manipulate were the basic action-of-the-market indicators and examples of these are the movement of the averages, the movements of the bond market, the daily highs and lows, the movement of the daily most-active stocks, the advances and declines, etc. After all, how can any man or group of men manipulate the daily new high list, or the number of stocks advancing on a given day? Or how can the action of the D-J Industrials, Transports, Utilities and bonds all be deceptive over a period of a few days or weeks?



The answer (and the passage of time has made me absolutely certain of this) is that no one can manipulate the action of 4 or 5 basic indicators for more than a day or so. And to manipulate 8 indicators is totally impossible. After much testing, experimenting and re-testing, I arrived at my Primary Trend Index, which is

an amalgam of 8 critical indicators and averages. I worked out a method of combining these 8 indicators so that they would produce a daily value, and in early 1971 I began computing and charting the PTI.

My thinking was that the PTI would move in the direction of the great tide of the market, and that during periods of confusion and attempted manipulation, the PTI would reveal "the real market story."

I followed the PTI all through the difficult markets of 1971 to 1973. Then during 1973 and 1974 I saw the PTI crumble as the great bear market hit. In late-1974 the PTI turned up and it has been in a major rising trend ever since. The PTI was particularly interesting during mid-1976 to mid-1977. It continued to rise even as the Dow declined. A severe decline took the PTI down from late-1977 to February, 1978. In February of 1978 the PTI turned up and it has been rising on both a primary and secondary basis ever since (see page 3 long term chart).

Turning to the daily chart (page 3, bottom) of the Dow, the A-D ratio, and the PTI, it is obvious that there is a discrepancy between the various indicators. The Dow has been behaving well, having recorded a November 20 high of 1000.17. This is still below the 1973 record high of 1051.70 but the Industrials are moving in the right direction.

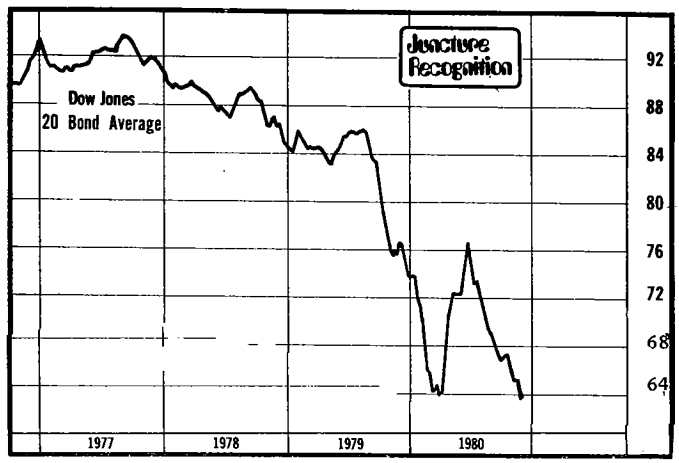
The PTI on September 20 hit a record high of 1377, and the persistent strength in the PTI is as remarkable as it is undeniable. Through all the recent August to October confusion the PTI pressed on above its rising trendline, and since late-October the rise in the PTI has been accelerating. One of my rules is that a persistently rising PTI builds pressure in the market boiler. Ultimately, that pressure will be expressed in higher prices, and that is exactly what has been happening.

The A-D ratio (which is a proxy for the entire universe of NYSE issues) has been stalling. Not only is the A-D ratio below its 1978 peak but its recent twin peaks of October 15 and 18 (both at minus 15.89) are in turn below the high for this year recorded on September 19 at minus 15.33. This has caused a great many analysts to predict trouble for the market, based on the traditional breadth-price divergence. My own inclination is to believe the PTI. I don't see trouble *until* the PTI peaks, then sinks persistently on a trend basis. This has NOT yet occurred.

The situation we now see is the PTI rising in the face of a record short position on the NYSE. The squeeze will be on the shorts until such time as the PTI turns down on a definite trend basis.

Note: I have had an increasing number of requests for the composition of the PTI and for my daily record of its values going back to 1971. I have only one secret in the market and it is the secret of the PTI. I would gladly make the PTI public except for one thing: as soon as thousands of people began computing and following the PTI, it would be on its way to "bombing out." In the stock market, widely-followed devices lose effectiveness in direct proportion to their following.

MONEY RATES: Hardly a day goes by without some "name" analyst announcing that interest rates are at or near "the peak." I've been somewhat skeptical, and my skepticism continues. Last week certain municipal indices that I follow broke to new lows. The prime rate popped to the 18% level, and business loans continued to rise. The long-term Government bond market held steady, but on November 26 the D-J 20-Bond Average dropped to 63.72. This was below its earlier 1980 low and was the lowest reading for the 20 Bonds on record! The chart shows this picture rather dramatically (chart courtesy of Juncture Recognition, Box 1209, Pompano Beach, FL 33061).



The conventional wisdom holds that as and if business slows, interest rates will decline (simple, slower business equals less need for money). I'm skeptical of this scenario too. My own fear is that with corporations still illiquid and swimming in debt, any slowdown could bring on a new flood of requests for money. In the WSJ of November 28 an example is cited. Massey-Ferguson paid $57 million in 1974 to service $505 million in debt. This year on $1.7 billion in debt Massey needs about $300 million. The question is – where the hell are they going to get it? Multiply this by 100 or so times and you get a mess. And that's what I think could happen if the economy turns from stag-flation to slump.

So I'm personally not willing to go out more than 6 months on maturities, and I'm not yet willing to bet that "the peak in interest rates has arrived."

NOTES ON DEBTS: I have received more comment on the "Tell Them" section of the last Letter (page 6) than anything I have written in a long time. Evidently, people are ready to hear the truth. If so, consider this quote from former Treasury Secretary George Schultz (Schultz is now head of Reagan's economic strategy panel): Said Schultz on Nov. 16, *"The situation Reagan will inherit is gloomy. We have very high inflation by any historic standard. If we have a recovery at all, it's a very fragile recovery...The Federal budget is hemorrhaging – out of control, it's a very bad scene."* Schultz added that the new Administration would have to take "strong and decisive" action.

* *

Here's a most valuable concept written by a true market student, R.E. McMasters, publisher of *The Reaper*, PO Box 39026, Phoenix, AZ 85069: *"It takes a disciplined and mature trader to know where a market is going, and still stay out because he can't handle the risk. In such an environment, as the present one, every man must search his own soul, evaluate his own psychological and financial strength, and then make his own trading decisions. The yellow brick road has run out."*

* *

T.J. Holt (Holt Executive Advisory, 290 Post Rd. West, Westport, Conn. 06880) states that *"Chrysler now has no book value at all. Losses through October, we estimate, have wiped out the $1.6 billion shareholders' equity prevailing at the start of the*

year. Worse yet, this underwater company will probably run out of Government aid this winter and out of cash by spring. Will the company get new Federal help? Probably not..."

* *

Aw c'mon: I don't want to be mean but isn't this cartoon a cutting commentary on American industry? (courtesy of *Penthouse*).

"When did Santa move his workshop to Japan?"

* *

In all honesty, what other publication do you know of that documents the impending bankruptcy of the US in such detailed, up-to-date reports? *Dow Theory Letters* stand virtually alone in the "debt and bankruptcy" field. This week the feature is "Big T." Everyone knows that Big D is Dallas, but what's Big T? Big T is the big trillion, the trillion dollars in federal debt that the US will probably hit in 1981 – for the first time. Here's the story through Nov. 19, and we're moving up FAST.

Government Finances

WASHINGTON (AP)-Here are figures on government spending and debt (last six digits are omitted). The government's fiscal year runs from Oct. 1 through Sept. 30.

Total public debt Nov. 19	912,149
Interest on public debt Sep	4,752
Interest fiscal year thru Sep	64,571 ←
Projected deficit fiscal 1981	29,766
Actual deficit fiscal 1980	58,961
Receipts fiscal year thru Sep	520,050
Receipts period last year	465,955
Outlays fiscal year thru Sep	579,011
Outlays period last year	493,607
Gold for Aug	11,172

Chase Manhattan's Braverman predicts a budget deficit of $85 billion for 1981 (including off-budget financing). Adoiphson of Bear Stearns predicts a $100 billion deficit for 1981 (including off-budget). Note that many corporations are now withdrawing their bond issues "in view of current market conditions." But do you know who will not withdraw its financing? The US Government, and the whole process we see now is called "crowding out." That's right, the debt-swollen US is now crowding out all other borrowers. If you liked 1980, you're going to love 1981.

If debt is the disease, interest rates are the fever. Here's a little comparison of key interest rates as Carter took over (Jan., 1977) and as Reagan prepares to take over. Interesting? Just keep building up the debt, boys! And to my subscribers here's some advice. For a long time it was clear that if you were a borrower you were smart and if you were a lender you were a sucker. The tables are about to be reversed, as we move into the era of "The Big Squeeze." It's pay-off time for the lender and saver now – but stay in short-term instruments!

Key Interest Rates

	11/7/80 (%)	Jan. 1977 (%)
Prime Rate	15.50	6.25
Three-month Treasury bills	13.10	4.73
Long-term Treasury bonds	12.48	7.56
New AA utility bonds	14.50	7.88
Federal funds	14.64	4.64
Prime commercial paper	15.00	4.90

* *

Forbes magazine used to pooh-pooh gold and "up up" the dollar. I guess times have changed (or *Forbes* has gotten smarter). Anyway, this rather exotic squib appeared in the December 1 issue of *Forbes*. Save it for your kids, it's a gem!

The money machine

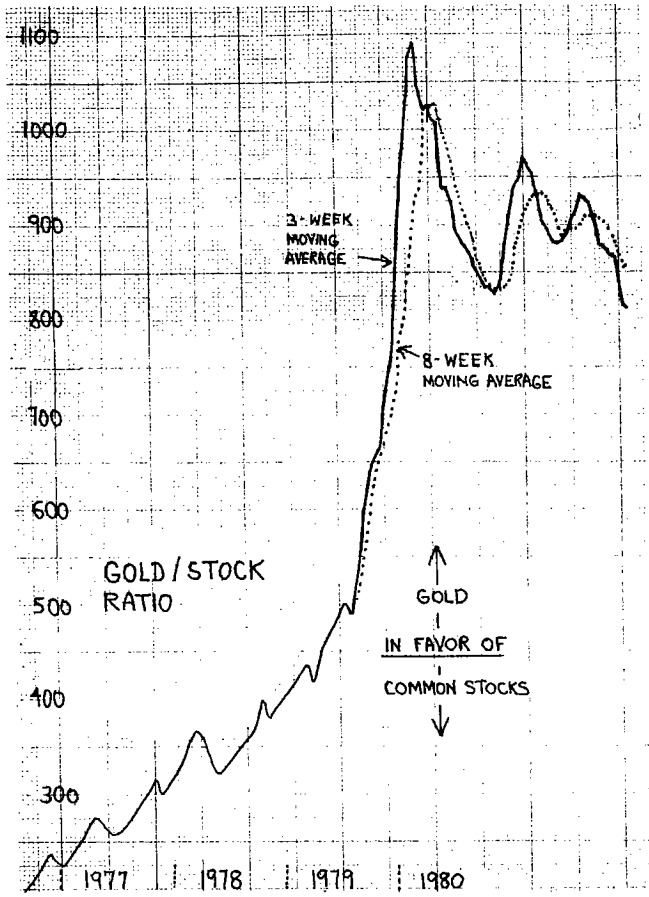
Uncle Sam's moneymakers at the Bureau of Engraving & Printing have just ordered two new printing presses—from De La Rue Giori S.A., a Swiss firm. ("We don't get much competition from American companies," a Bureau official says dryly.) The new machines can each turn out 384,000 greenbacks an hour, but the Swiss don't want any. De La Rue is taking payment in deutsche marks, 8.5 million of them.

GOLD/COMMON STOCKS: Which side are you on – gold or common stocks? This is a question that is kicked around and debated at all the "hard money" conferences, but to my mind it's pointless to debate the question. There's a market ratio that solves the problem for us, and it's a ratio that I keep up-dated in these reports.

The ratio is simply the price of gold divided by the price of the NYSE Composite Average (this includes all NYSE common shares). When the ratio rises, it is saying that gold is acting better than common shares. When the ratio declines, it is saying the opposite. I keep this ratio on the basis of a 3-week moving average (MA) and an 8-week moving average. These MA's simply smooth the path of the ratio. My formula is simple: When the 3-week MA is above the 8-week MA, be in gold. When the 3-week MA is below the 8-week MA be in common shares.

The 3-week MA hit its high of 1098 on January 31. On February 28 it gave the signal to switch out of gold and in to common stocks. The low point for the 3-week MA was recorded at 826 on May 29. That was the peak of strength for common stocks (over gold) for 1980. A series of minor fluctuations followed, but a few weeks ago (week of November 21) the 3-week MA (which was holding well below the 8-week MA) dropped to a new 1980 low of 825.

Thus the ratio is telling us that common stocks are now stronger (in relation to gold) than at any time since the ratio topped out in January 1980. This brings up some questions. Could the markets way back in January have foreseen that Reagan would be the winner? Could the market have foreseen that forces friendly to common stocks and neutral or bearish for gold would materialize? For whatever mysterious reasons, the ratio did hit its peak



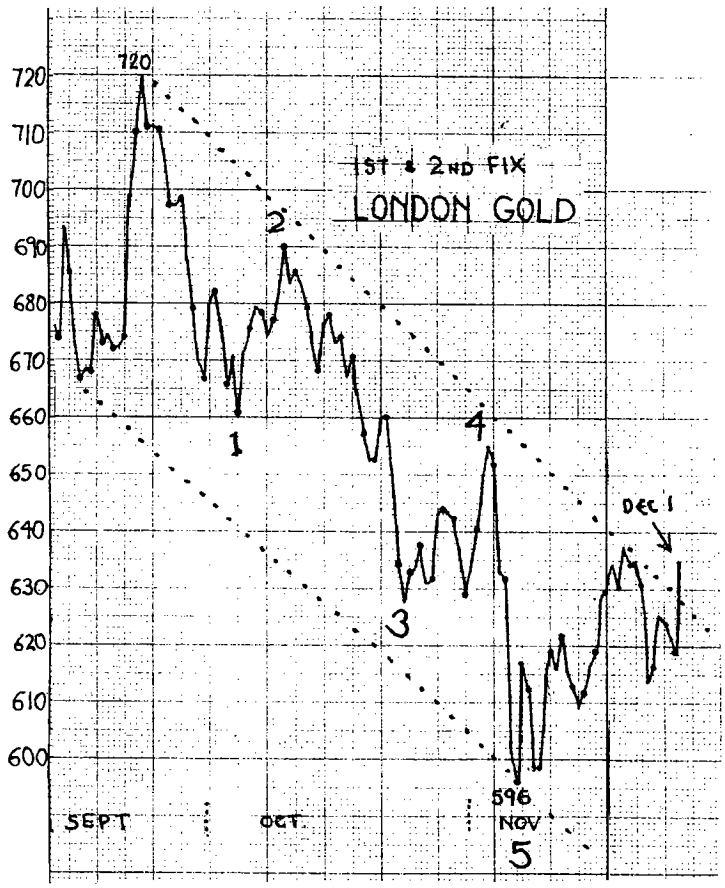
in favor of gold back in January. For whatever reason, the ratio hit its low for the year a few weeks ago. Thus the market is telling us that common stocks have been the winner over gold during 1980. The tip-off was provided last January and confirmed last week – it's all in the chart.

GOLD: Well, more and more analysts, holders and even gold bugs are turning luke warm to chilly on gold, but with it all the metal has held above 600. This is all to the good, and as I said in the last Letter, the longer gold holds 600 and the more time elapses and the more bearish people become about gold – the more hopeful the outlook.

I must admit that the near-term or daily chart looks better than the long-term chart, but the story is still being told. On the daily chart note that gold has corrected down from its September high of 720, and the correction has taken the form of 5 waves down – all within a descending channel. Now 5 waves down usually completes a movement, so it was not surprising to see gold correct upward following the termination of the 5th wave at a price of 596 in early November.

The action since the 596 low took gold up to 638, which was just about at the top of the channel. If that was all the upward correction we're going to see, then I'd say that the outlook for gold is somewhat discouraging. It would be much more encouraging to see gold break out of the channel on the upside, then push above the last peak or above the 640 level. So far, gold has not been able to do that, and I'm waiting to see more.

This week's statistics on gold are as follows: the 13-week rate of change (momentum) for gold is 99. But the average price for



gold will have to move into the 640's from here or momentum is going to slide.

The long-term or 50-week moving average (MA) for gold is now 582, a new high. The 13-week or intermediate-term MA for gold is now declining and stands at 638. The 5-week or short-term MA for gold is also declining and has dropped to 627, 11 points below the 13-week MA. As long as gold holds below 625, the 5-week and 13-week MA's will be declining. The 582 or 50-week MA for gold is of paramount importance, and gold should find massive support at this level. I would take any move below 582 as a definitive signal for a period of forthcoming deflation in the economy.

LATE MARKET NOTES: The market up-trend is showing some signs of fatigue. Although the Dow was up 7 points on November 26, there were 6 more Dow issues down than up, a very rare reading. On November 28 (again) with the Dow up almost 4 points there were 5 more Dow issues down than up. On the same day the total breadth on the NYSE showed 90 more issues down than up. The market acted as if it was "out of breath."

Nevertheless, November 28 saw the PTI push up to a new record high of 1381 and thus my primary indicator continues to fight against other signs of market exhaustion. As long as the PTI is rising I consider the trend of the market to be up. The long string of record highs in the PTI (despite other technical caution signals) has been extraordinary. If there's weakness in the PTI, it has not shown itself at this writing. And I don't turn bearish on the market until the trend of the PTI is down.

NEXT MAILING: December 17th